Securities Investor Protection Act of 1970

Purpose of 1970 Act

When the rate of stockbroker failures accelerated in the late 1960's and in 1970, Congress responded by enacting the Securities Investor Protection Act of 1970 ("1970 Act") whose several purposes were stated thusly in the Senate Committee Report:

> "... to protect individual investors from financial hardship; to insulate the economy from the disruption which can follow the failure of major financial institutions; and to achieve a general upgrading of financial responsibility requirements of brokers and dealers to eliminate, to the maximum extent possible, the risks which lead to customer loss." S.R. No. 91-1218, 91st Cong., 2d Sess. 4 (1970); see also H.R. No. 91-1613, 91st Cong., 2d Sess. 1 (1970).

The 1970 Act created the Securities Investor Protection Corporation ("SIPC") and, among other things, established new procedures for broker-dealer liquidations.

Status and Organization of SIPC

As this Court knows the securities industry is a self-regulated one over which the Securities and Exchange Commission ("Commission") has rulemaking and enforcement responsibilities. The regulatory function is essentially performed by the self-regulatory organizations, namely, the national securities exchanges and the National Association of Securities Dealers, Inc. The creation of SIPC was not intended to alter that system of self-regulation with Commission oversight, but rather to provide a vehicle within that system for the protection of customers of failed broker-dealers.

Under Section 3(a) of the 1970 Act[1] SIPC is organized as a nonprofit membership corporation, not an agency of the United States Government, with the powers and duties prescribed in the 1970 Act and those of a nonprofit corporation organized under the District of Columbia Nonprofit Corporation Act. Its business relates primarily to the protection of customers of broker-dealers in financial distress, in accordance with the substantive and procedural requirements of the 1970 Act.

The SIPC Board

Section 3(c)[2] establishes a seven-member Board of Directors which is vested with the responsibility to determine SIPC's policies (subject to Commission oversight, discussed below). The Secretary of the Treasury and the Federal Reserve Board each designate a director from among their respective officers and employees, and the President of the United States appoints (subject to Senate confirmation) the remaining five directors, three of whom must be selected from the securities industry and two from the general public. This provision not only reflects the self-regulatory character of the industry, but also takes into account the public interest and the potential exposure of one billion dollars of public funds (discussed below).

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[1] 15 U.S.C. § 78ccc(a). For convenience, references in the text to sections not otherwise identified are to sections of the 1970 Act. Similarly, footnote references not otherwise identified are to 15 U.S.C.

[2] § 78ccc(c).

SIPC's Members

The cost of providing protection to customers under the 1970 Act was intended to be borne by the industry itself. This was accomplished by mandating membership in SIPC for all broker-dealers registered under the Securities Exchange Act of 1934 ("Exchange Act") and all persons who are members of a national securities exchange, with certain exceptions, as provided in Section 3(a)(2).[3] However, the 1970 Act does not confer on the membership any rights to determine, or vote with respect to, the policies or operations of SIPC. Nor do they have such rights under the laws of the District of Columbia which, as applied to SIPC, vest all voting power and authority in the Board of Directors [D.C. Code § 29-1016 (d)]. In essence, SIPC membership is a device for establishing the liability of covered broker-dealers for the payment of assessments which provide the fund that protects customers. Except for their liability for assessments, Section 11(c)[4] specifically protects members from any liability as a member, among other things.

The SIPC Fund

The 1970 Act became law on December 30, 1970. Section 4[5] required SIPC to establish a "SIPC Fund" (to consist of cash, U. S. Government securities and confirmed lines of credit) of not less than 75 million dollars (less prior expenses) within 120 days from the enactment of the 1970 Act. It is a public fact that this was achieved *via* a 65 million dollar confirmed bank line of credit, with the

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[3] § 78ccc(a)(2).

[4] § 78kkk(c).

[5] § 78ddd.

remainder derived from stock exchange trust fund contributions and assessments on SIPC's members as provided in Section 4(c).[6]

Assessments

The amount of assessments on members of SIPC is prescribed by Sections 4(c) and (d).[7] Section 4(c)(2)[8] confers general assessment authority upon SIPC, including the power to vary assessments depending on relevant factors. The present assessment is the minimum required by Section 4(d)(1)(A)[9] until the SIPC fund aggregates not less than 150 million dollars.

Collection of Assessments

Although SIPC determines the rate or amount of assessments, the responsibility for collections from members of self-regulatory organizations rests with those organizations.

Under Section 8[10] each SIPC member is required to file certain financial information respecting its revenues so that its assessment liability can be ascertained. However, the member files that information with the "self-regulatory organization" which is the member's "examining authority" within the self-regulatory scheme.[11] Section 9(a)[12] des-

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[6] § 78ddd(c).

[7] §§ 78ddd(c) and (d).

[8] § 78ddd(c)(2).

[9] § 78ddd(d)(1)(A).

[10] § 78hhh.

[11] "Self-regulatory organization" and "examining authority" are defined in Sections 12 (1) and (3) [§§ 78lll(1) and (3)]. If a broker-dealer is not a member of any self-regulatory organization, it must file the information with the Commission which, in such circumstances, would be its "examining authority".

[12] § 78iii(a).

ignates the responsible "examining authority" as agent for the collection of assessments, and further provides for direct remittance to SIPC by the small number of broker-dealers who are not members of any self-regulatory organization. Assessments received by the self-regulatory organizations are transmitted to SIPC.

U. S. Treasury Funds

The 1970 Act recognizes that a dire crisis in the securities industry could well exhaust the SIPC Fund. To guard against that contingency a borrowing of one billion dollars from the U.S. Treasury is authorized in accordance with procedures set forth in Sections 4(g) and (h).[13] Such a borrowing is effected through the Commission which must itself determine that the loan is necessary for the protection of customers, among other things. Repayment by SIPC and its members is contemplated, and provision is made whereby the normal annual assessments received from members can be augmented.

SIPC's Role in Self-Regulatory Scheme

Except for a few limited powers granted to SIPC with respect to the self-regulatory organizations in areas of immediate interest to SIPC [Sections 9 (c) and (d)],[14] SIPC's role is one of consultation and cooperation with the self-regulatory organizations as provided in Section 9(e).[15] The self-regulatory organizations remain subject to the federal securities laws and the rules of the Commission.

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[13] §§ 78ddd(g) and (h).

[14] §§ 78iii(c) and (d).

[15] § 78iii(e).

Commission Oversight

The 1970 Act grants the Commission considerable control over SIPC. The Commission is vested with authority by Sections 3(e)(2) and (3)[16] to approve or reject any bylaw or rule adopted by SIPC's board, and indeed to require the amendment or rescission of any bylaw or rule adopted by SIPC. The Commission was also authorized to determine when SIPC shall phase out all confirmed lines of credit constituting a part of the SIPC Fund [Section 4(d)(2)(B)],[17] to approve SIPC's treatment of any trust funds which it might receive from any self-regulatory organization for purposes of reducing assessments [Section 4(e)(1)],[18] to determine whether the aforementioned borrowing from the U.S. Treasury is necessary [Section 4(g)],[19] to determine that the disclosure of any notice, report or other document filed with SIPC is not in the public interest [Section 11(a)],[20] and to determine the extent to which the provisions of the 1970 Act shall apply to the foreign operations of a SIPC member [Section 11(b)].[21]

In addition to its oversight of SIPC management and operations, the Commission is further authorized to adopt rules varying the 1970 Act insofar as it defines specifically identifiable property which must be returned to customers [Section 6(c)(2)(B)(iii)],[22] and to prescribe which open

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[16] §§ 78ccc(e)(2) and (3).

[17] § 78ddd(d)(2)(B).

[18] § 78ddd(e)(1).

[19] § 78ddd(g).

[20] § 78kkk(a).

[21] § 78kkk(b).

[22] § 78fff(c)(2)(B)(iii).

contractual commitments between the liquidating broker-dealer ("debtor") and other broker-dealers will be completed by the trustee in liquidation [Section 6(d)]."[23] In fact the Commission has exercised that power by promulgating Rules 15c3-3(j) and S6d-1 [17CFR 240.15c3-3(j); 17CFR 240.206d-1].

A major grant of authority and oversight to the Commission is contained in Section 7(b)[24] which authorizes the Commission to commence suit against SIPC to require it to discharge its obligations under the 1970 Act in the event SIPC refuses to commit its funds or otherwise to act for the protection of customers. The 1970 Act grants additional powers to the Commission which need not herein be enumerated.

Customer's Rights Pre-1970 Act

Prior to 1938 customers of a stockbroker in bankruptcy were entitled to the return of their securities and cash which could be traced as their property; as to such property their rights were superior to the claims of general creditors. See, *e.g., Duel* v. *Hollins,* 241 U.S. 523 (1916); *Gorman* v. *Littlefield,* 229 U.S. 19 (1913); *Richardson* v. *Shaw,* 209 U.S. 365 (1908); *Sexton* v. *American Trust Co.,* 45 F. 2d 372 (8th Cir. 1930); see, also, 3 Collier on Bankruptcy ¶ 60.72, pp. 1159-1165 (14th ed. 1971). However, the rights of customers *inter se* varied to some extent from jurisdiction to jurisdiction and there arose some inequality in the treatment of customers. See *Tepper* v. *Chichester,* 285 F. 2d 309, 311 (9th Cir. 1960); *In re McMillan, Rapp & Co.,* 123 F. 2d 428, 431 (3d Cir. 1941); 3 Collier, *op. cit. supra,* ¶¶ 60.72, 60.73, pp. 1159-1165, 1168 n.10.

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[23] § 78fff(d).

[24] § 78ggg(b).

As part of the Chandler Act, in 1938 Congress enacted Section 60e of the Bankruptcy Act [11 U.S.C. § 96(e)] in order to achieve greater equality of treatment of customers. That Section permitted cash customers, *as defined,* to reclaim cash or securities which could be specifically identified as their property within the statutory definition. Otherwise, it provided that cash, securities or property of similar character held for customers (but not specifically identifiable to particular customers) would be a "single and separate fund" to be applied in satisfaction of customer claims (other than for specifically identifiable property) on a *pro rata* basis. These customer claimants were described as a "single and separate class of creditors". Such a claim was for the "net equity" of his account, determined by subtracting the customer's indebtedness to the broker from the sum the broker would have owed the customer had the customer's securities (other than specifically identifiable property) and securities commitments been liquidated on the date of bankruptcy. Except for specifically identifiable property, customers were entitled only to a ratable participation in the "single and separate fund". As for the unpaid balance of their net equities, they were included among general creditors. A more detailed discussion of Section 60e may be found in 3 COLLIER, *op. cit. supra,* ¶¶ 60.72-60.76, pp. 1166-1201.

CUSTOMER PROTECTION UNDER 1970 ACT

SIPC is not an insurer in the usual sense. Its role is carefully delineated by the 1970 Act which establishes special procedures for the liquidation of financially distressed broker-dealers which are members of SIPC. Briefly, the statutory scheme works like this.

Nature of SIPC Proceeding

Under Section 5(a)(1),[25] if the Commission or any self-regulatory organization believes that a broker or dealer subject to its regulation is in, or is approaching, financial difficulty, it must immediately notify SIPC. Under Section 5(a)(2),[26] if SIPC determines that a member broker-dealer has failed or is in danger of failing to meet its obligations to customers, and that one or more of certain statutory conditions exist (for example, insolvency), it *may* apply to the appropriate federal district court for an order adjudicating that the customers of such member need the protection of the 1970 Act. If SIPC's determination is unchallenged, or sustained after contest, the court is required to issue a decree adjudicating that the firm's customers require protection, and appointing a trustee and counsel designated by SIPC for the liquidation of the firm's business.

A proceeding under the 1970 Act is a liquidation proceeding; reorganization is specifically prohibited [Sections 6(a) and (c)(1)].[27] The trustee has the same powers as a trustee in bankruptcy and a trustee under Chapter X of the Bankruptcy Act, and provision is made for the applicability of Chapter X of the Bankruptcy Act and certain provisions (other than Section 60e) of Chapters I to VII of the Bankruptcy Act [Sections 6(b) and (c)(1)].[28] The proceeding not only disposes of claims of customers, but also the claims of general creditors. Section 6(e)[29] provides for

[25] § 78eee(a)(1).

[26] § 78eee(a)(2).

[27] §§ 78fff(a) and (c)(1).

[28] §§ 78fff(b) and (c)(1).

[29] § 78fff(e).

prompt notice to customers and for their filing of claims within a specified time.

Customers' Rights Under the 1970 Act

Although it made some important changes the 1970 Act substantially tracked the provisions of Section 60e of the Bankruptcy Act [S.R. No. 91-1218, 91st Cong., 2d Sess. 11 (1970); H.R. No. 91-1613, 91st Cong., 2d Sess. 10 (1970)]. Thus customers are entitled to the return of their specifically identifiable property, as defined in Sections 6(a)(1)(A) and (c)(2)(C)[30] and the Commission's Rule 15c3-3 (j). Section 6(c)(2)(B)[31] continues the concept of a "single and separate fund" available for the satisfaction of the "net equity" claims of customers who are regarded as a single and separate class of creditors entitled to share ratably in such fund. The net equities of customers are computed as of the date SIPC initiates the liquidation proceeding, or an earlier date if the SIPC proceeding was preceded by (1) the filing of a petition in bankruptcy by or against the broker-dealer, or (2) a proceeding against the broker-dealer in which a receiver, trustee or liquidator was appointed [Sections 5(b)(4)(B) and 6(c)(2)(A)(iv)].[32] The applicable date is called the "filing date."

The total subject matter of Section 60e of the Bankruptcy Act is covered in Section 6(c)(2),[33] and as noted earlier the former Section is specifically made inapplicable thereby limiting its utility to failed firms whose judicial liquidations, for one reason or another, are not effected under the 1970 Act.

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[30] §§ 78fff(a)(1)(A) and (c)(2)(C).

[31] § 78fff(c)(2)(B).

[32] §§ 78eee(b)(4)(B) and fff(c)(2)(A)(iv).

[33] § 78fff(c)(2).

Completion of Open Contractual Commitments

As already stated (*supra*, page 1a) one of the broad purposes of the 1970 Act was "to insulate the economy from the disruption which can follow the failure of major financial institutions." Thus, Congress sought not only to protect customers of the debtor, but also to provide a measure of indirect protection to customers of other brokers and dealers doing business with the debtor. This was done *via* Section 6(d)[34] and the Commission's Rule S6d-1 thereunder authorizing the trustee to complete certain open contractual commitments between the debtor and other brokers and dealers.

Use of SIPC Funds to Satisfy Customer Claims

As already indicated customers file claims with the trustee who determines their validity. This is a claims program on an expedited basis. If a customer has a valid claim for securities, the trustee delivers those securities to the extent they are available after making any necessary or permissible allocation among customers claiming the same securities [Sections 6(c)(2)(B)-(D), 6(e) and 6(g)].[35] A cash payment from the single and separate fund is made in lieu of missing securities based on "filing date" values. Of course, claims for cash are payable in cash.

As a supplement to the assets in the trustee's hands, Section 6(f)[36] requires SIPC to advance funds to the trustee for the purpose of satisfying customers' net equity claims. However, SIPC may not advance more than $50,000 per customer of which not more than $20,000 may be for

[34] § 78fff(d).

[35] §§ 78fff(c)(2)(B)-(D), fff(e) and fff(g).

[36] § 78fff(f).

that portion of a customer's claim which is for cash, as distinct from securities. Not only is there a limitation upon the amounts available from SIPC, but it is also provided that SIPC funds are not available to satisfy claims of certain customers. Thus Sections 6(f)(1)(C) and (D)[37] prohibit the use of SIPC funds for certain principals of the debtor as well as claims of other brokers or dealers or banks not involving transactions for their customers.

Under Section 6(f)(2)[38] SIPC must also advance funds to complete certain open contractual commitments between the debtor and other broker-dealers, and may also do so for certain administrative expenses of the proceeding.

SIPC's Recoupment of Funds

As the foregoing demonstrates, SIPC does not simply pay claims as would an insurer. Moreover, its advances of funds are recouped from the debtor's assets to the full extent possible. Under Section 6(f)(1)[39] SIPC is subrogated to the rights and priorities of customers under the 1970 Act to the extent of its advances. Those rights are not only against the single and separate fund, but also against the debtor's general estate [Section 6(c)(2)(B)[40]]. In addition, funds advanced by SIPC for administrative expenses are recouped from both the general estate and the single and separate fund, to the extent assets are available (*Ibid.*). Such expenses enjoy priority under Sections 64a (1) and (2) of the Bankruptcy Act. [11 USC §§ 104a(1) and (2)].

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[37] §§ 78fff(f)(1)(C) and (D).

[38] § 78fff(f)(2).

[39] § 78fff(f)(1).

[40] § 78fff(c)(2)(B).